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Working through Benefit-Responsive Investment Contract Guidelines

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The Financial Accounting Standards Board's (FASB's) Staff Position (FSP) AAGINV-1 and SOP 94-4-1, which is effective for periods ending after Dec. 15, 2006, significantly changed the reporting of certain guaranteed investment contracts in the financial statements of defined contribution pension and health and welfare plans. This FSP effectively removed the scope exception provided for fully benefit-responsive investment contracts reported at contract value in accordance with SOP 94-4, thus requiring these contracts to be reported at fair value. The FSP also requires additional financial statement disclosure. Defined benefit plans are not affected by this FSP and continue to report investment contracts at fair value.

AICPA issued three Technical Practice Aids (TPAs) to provide guidance related to the FSP. TPA 6931.08 defined the investments where the FSP applies: traditional or separate account guaranteed investment contract (GIC); a bank investment contract (BIC); a synthetic GIC composed of a wrapper contract and the underlying wrapped portfolio of individuals; or a contract with similar characteristics. TPA 6931.09 disclosed the FSP's application to a plan's investment in a common collective trust (CCT) fund or a master trust that holds fully benefit-responsive investment contracts. TPA 6931.10 provided guidance on disclosure requirements when a plan invests in CCT funds or a master trust that holds fully benefit-responsive investment contracts.

GICs are very popular with defined contribution plan sponsors and participants due to their relatively high yield, stability of return, and safety of principal. GICs are individually negotiated between the purchaser and the issuer to provide for liquidity, which protects the plan participant from fluctuations experienced in the market. Generally, the issuer will absorb the risk and provide participants with full book value when they withdraw from the fund. This is noted in the FSP, which states that although the requirement is to report these fully benefit-responsive contracts at fair value, contract value is the relevant measurement because contract value is the amount participants would receive if they were to initiate permitted transactions under the terms of the plan.

To be considered fully benefit-responsive, contracts must meet the following criteria: the contract must be between the plan and issuer, and cannot be sold or assigned; the contract issuer must be obligated to repay principal and interest or provide prospective crediting rate adjustments that cannot be less than zero; all participant-initiated transactions occur at contract value; an event that limits the ability to transact at contract value is not probable; and the plan must allow participants reasonable access to their funds. Plans may hold these investments through direct contracts with issuers, ownership of CCTs, or pooled separate accounts.

The required financial statement presentation is in the statement of net assets available for benefits. The change is reflected in all investments at fair value to include those for which the FSP applies, such as GICs, BICs, and so on. The difference in fair value and contract value is presented as a single line item, and is disclosed as "Adjustment from fair value to contract value for fully benefit-responsive investment contracts," and the final presentation of net assets available for benefits. Footnote disclosure requirements include the nature of the contracts, how they operate, the methodology for calculating the interest crediting rates, key factors that could influence future average interest crediting rate resets, minimum interest crediting rate, and the relationship between future interest crediting rates and the adjustment to contract value reported in the statement of net assets available for benefits.

This FSP affects financial statement reporting for plans that begin after Dec. 15, 2006. In accordance with AU Section 328.04, plan sponsors had the responsibility to assess the fair value of these investments for plan years ended Dec. 31, 2006, to evaluate differences in fair and contract value, and to calculate the adjustment for the current and prior years presented in accordance with the FSP. Valuation and auditing procedures have been significantly affected. In full-scope audits, valuation testing includes, but is not limited to, assessment of the model, testing of inputs, and value and materiality considerations. Limited-scope audits require additional certifications for these investments from trustees and/or custodians, and if they are not

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obtained, the necessity to perform full-scope procedures in respect to valuation of these investments.

As we approach the second year of the implementation of this FSP, there is an expectation that the level of uncertainty has declined as sponsors gain an understanding of the requirements and their role in the valuation process. The difficulties experienced in the first year of implementation may have been alleviated, but that remains to be seen. ■

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